Fund Democracy
Consumer Federation of America
Consumer Action
Consumers Union

April 5, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. S7-06-04

Dear Secretary Katz:

We are writing on behalf of Fund Democracy,[1] Consumer Federation of America,[2] Consumer Action,[3] and Consumers Union[4] in response to the Commission's request for further comment on its proposal to improve disclosure of mutual fund costs and sales-related conflicts of interest at the point of sale and on confirmation statements.[5] We hereby incorporate by reference

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[1] Fund Democracy is a nonprofit advocacy group for mutual fund shareholders. It was founded in 2000 to provide a voice and information source for mutual fund shareholders on operational and regulatory issues that affect their fund investments.

[2] The Consumer Federation of America (CFA) is a nonprofit association of approximately 300 national, state, and local consumer groups, which in turn represent approximately 50 million Americans. CFA was established in 1968 to advance the consumer interest through research, education, and advocacy.

[3] Founded in 1971, Consumer Action works on a wide range of consumer issues through its national network of 7,500 community based organizations.

[4] Consumers Union, publisher of *Consumer Reports* magazine, is an independent nonprofit testing, educational and information organization serving only the consumer.

[5] "Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and

our comment letter dated April 21, 2004. This letter focuses primarily on concerns regarding the point-of-sale ("POS") disclosure requirement.

We again applaud the Commission's efforts in connection with this proposal, as well as steps it has taken since its original proposal, to improve price transparency and prevent abusive sales practices in the fund industry:

- The Commission's decision to ban directed brokerage eliminates a form of sales compensation that simply is not susceptible to the market discipline provided by full disclosure or the investor protection provided by regulatory oversight.[6]

- The Commission's decision, reflected in this re-proposal, to include fund operating expenses in the POS disclosures will substantially improve mutual fund price transparency. This is an essential improvement, as the Commission's own testing indicates that a significant percentage of investors would be misled about the total costs of their mutual funds if this information were omitted.[7]

- The Commission's decision to test proposed disclosures for readability and clarity – and its decision, reflected in this re-proposal, to require disclosures to be provided in a standardized, easy-to-read format developed through that testing process – will help to ensure that the resulting disclosure documents are useful to and used by investors.

- The Commission's position, clearly stated in this re-proposal, that simply providing information on the Internet is not a substitute for direct delivery of key information at the point of sale reflects an important awareness of the difference between making information available to investors and bringing it to their attention.[8]

- The Commission's request for comment on the timing of the disclosures reflects a willingness to consider requiring the disclosures earlier in the sales process so that investors have adequate time to consider the information.

Amendments to the Registration Form for Mutual Funds," Investment Company Act Rel. No. 26788 (March 1, 2005) (hereinafter, "Release").

[6] We encourage the Commission to use its inspection and investigative resources to ensure that fund managers do not continue to allocate fund brokerage to provide brokers with hidden compensation for the sale of fund shares.

[7] Results of In-Depth Investor Interviews Regarding Proposed Mutual Fund Sales Fee and Conflict of Interest Disclosure Forms, Report to the Securities and Exchange Commission from Siegel & Gale, LLC and Gelb Consulting Group, Inc., November 4, 2004.

[8] As discussed further below, we do believe that electronic means of communication can provide an effective point-of-sale disclosure tool if properly utilized.

- The Commission's application of the proposed rules to broker-sold 529 plans is an important step toward rectifying a glaring gap in the mutual fund regulatory scheme, which has left investors in these plans without access to uniform disclosures.[9]

While we believe the Commission's re-proposal makes strides toward meaningful price transparency for mutual funds, we continue to have significant concerns in several areas. In particular, we are concerned that a number of the steps the Commission has proposed to simplify the disclosures have undermined their ability to serve their intended purpose. With comparative information removed, the documents no longer give investors any sense of the extent of the conflict of interest at work or how the costs compare to those of other funds. Because 12b-1 fees are grouped with annual operating expenses, the disclosures even fail to make a clear distinction between what the investor pays for the services of the broker in selling the fund and the costs associated with operating the fund. Finally, by allowing quantitative information about revenue sharing payments to be relegated to the website, the proposal risks encouraging increased use of a compensation method that, like the now banned use of directed brokerage, encourages brokers to recommend funds that are not in their customers' best interests.

All of these key shortcomings relate to two general problems with the Commission's approach to this issue. First, the Commission appears to assume that disclosure requirements must be designed to conform to existing compensation practices, even where those practices are demonstrably harmful to investor interests. As a result, the quality of disclosure is undermined in order to avoid imposing "excessive" costs on brokers. Second, the Commission has approached this issue as a mutual fund issue when it is, in fact, primarily a broker-dealer concern involving issues with implications far beyond the sale of mutual funds. As a result, investors will get information about only those conflicts of interest that bias a broker's recommendations of mutual funds (and related products covered by the rule) and will not receive information about similar conflicts that may bias the recommendation of those products not covered by the rule.

Complexity, Cost and Transparency

The Commission's approach to compensation disclosure seems to be based on a fundamental misunderstanding of the relationship between the way in which fees are disclosed and the way in which broker compensation is set. Fee disclosure rules and fee arrangements are not independent variables. Rather, they are mutually dependent variables that continuously interact. The current complex compensation structure for brokers is, in that sense, a direct result of the lack of effective disclosure. Had brokers been forced from the outset to disclose their compensation, they would likely have been considerably less inclined to adopt compensation practices that were inherently costly to disclose. Similarly, the use of revenue sharing, directed

[9] We hope that the Commission will continue its efforts to protect investors from inferior investment products and abusive sales practices that have proliferated in this area by, among other things, examining how the disclosures of direct-sold 529 plans could also be improved.

brokerage, and 12b-1 fees to compensate brokers all grew up at least in part as a means of funneling more broker compensation into forms that are less transparent to investors than front-end sales loads.[10] Now they argue that disclosures should be weakened in order to perpetuate compensation arrangements that would not have developed in an environment of full disclosure.

In order to eliminate the current system's incentive to compensate brokers in the least transparent way possible, the Commission should adopt simple principles for the timing, content, and format of disclosures and apply them to all forms of broker compensation. The goal should be to provide investors with the information they need, in a form they can understand, at a time when it is useful to them. Thus, if investors need information on costs and conflicts at the point when a product is recommended (so that they have time to factor it into their investment decision), that and *not* prevailing sales practices among brokers should determine the timing of the disclosure. Similarly, if investors need information that helps them measure the extent of any conflict of interest, that and *not* the complexity of existing compensation practices should determine the content of the disclosures.

Decisions to provide certain information on the Internet, or through a toll-free number, should be dictated, not by the complexity of the information being disclosed, but by its importance to the investor. Only information of secondary importance should be relegated to this secondary position, where it is significantly less likely to be reviewed by the investor.[11] Thus, sound principles of disclosure should dictate that investors' attention is actively directed to the most critical information, while only requiring that less critical, albeit important, information be easily accessible. In the context of the POS disclosures, this means critically important information should be provided on the document, and that only less important information should be relegated to Internet-based disclosure.

These principles are critically important to the effective functioning of market forces. If markets are to set prices, then prices must be transparent. Thus, the cost of price disclosure is a necessary cost of market-driven pricing. When brokers argue that detailed, written disclosure of the mutual fund fee arrangements would be too burdensome and costly because of the complexity of the compensation arrangements, they are in effect arguing that they, rather than market forces, should determine the structure of compensation arrangements. Similarly, their argument that differential compensation disclosure would be too costly and burdensome is an implicit acknowledgment that current compensation schemes could not survive if required to operate in a truly market-driven (fully disclosed) environment. But fee arrangements that cannot survive transparency – by reason of cost, complexity, or other factors – should be allowed to

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[10] Another motive likely was the ability to escape limits on sales loads, both limits set by regulators and those adopted in response to competition.

[11] As we discuss in greater detail below, we do believe, however, that electronic means of communication, including the Internet, can be used to deliver information to investors if they are used properly. This requires more than simply posting the information on the Internet, however.

expire. While brokerage firms could be expected to howl about excessive regulation, in reality any resulting change in compensation practices would be the result of the efficient operation of market forces, forces that are prevented from acting by the current lack of disclosure.

By moving important, but complex, information to the website, however, the Commission's re-proposal suggests that fully transparent pricing should be required only when it is consistent with the fee arrangements used by brokers. Imagine adopting this approach in the context of mutual fund fees, where standardized disclosure has been in place for years. In this hypothetical world, a fund manager might decide to change its fee structure to charge account fees for five different account sizes and redemption fees for five different holding periods. Disclosing these fees would be costly and burdensome, and the information would be difficult to convey clearly. Would the Commission therefore allow the fund to omit this information from the fee table and refer the investor to the fund's website for more information? If not, is the answer to this question "no" simply because the rules were in place before the new fee arrangement were created? Or is the answer "no" because, as we believe, the hypothetical fund's request is simply inconsistent with fundamental principles of fully transparent, market-based pricing?

If the Commission believes, as we do, that market forces should determine pricing arrangements, then it must allow those market forces to work by requiring all compensation methods to be subject to similar standards of disclosure. Failure to do so will ensure that brokers continue to develop and rely on new compensation structures designed to avoid full disclosure.

Inconsistent Disclosure Across Different Product and Professional Lines

Although the problems that led to the proposal of this rule arose in the context of mutual fund sales abuses, similar costs and conflicts apply to other products recommended by brokers. Because the Commission has approached this as a mutual fund issue, rather than as the broker-dealer issue it really is, the proposal creates a disclosure disadvantage for mutual funds compared with these other products.

The Securities Industry Association has reportedly argued that, if brokers are subject to "burdensome" disclosure obligations with respect to mutual funds, they will simply recommend other products instead. Brokers have made similar threats in the past – arguing, for example, that they would stop selling wrap accounts if those accounts were regulated as advisory accounts – and failed to follow through. However, the very fact that the brokers' trade association openly professes that brokers would abandon the sale of mutual funds, regardless of their customers' best interests, rather than disclose their costs and conflicts of interest is itself the best argument for why these disclosure obligations should apply across the board. Since the primary purpose of the rule proposal is to ensure that investors get adequate information about sales-related costs and conflicts of interest, and since these costs and conflicts are not unique to mutual funds, there is no logical reason why the disclosures should apply to only a sub-set of the products brokers recommend.

The solution, however, is not to water down the current proposal to the point of meaninglessness – by relegating all but the most general information to the website and eliminating the requirement for affirmative disclosure – nor is it to put the current rule proposal on hold while its requirements can be extended to other product areas. Instead, we urge the Commission to make a commitment to proceed immediately with comprehensive reform of broker-dealer cost and conflict of interest disclosure. As part of that comprehensive reform, the Commission should consider what information should be provided at the outset of the relationship, to help the investor make an appropriate selection among financial professionals, and what should be provided in relation to a specific product recommendation.

In this proposal, for example, the Commission has suggested that brokers be required to disclose on their website, if applicable: that the broker does not sell no-load funds, that the broker provides preferred salesperson access to fund complexes or other issuers that make revenue sharing payments; that the broker only distributes covered securities whose issuer pays a certain threshold of record-keeping-related fees, that all covered securities on the broker-dealer's preferred or select list of securities make revenue sharing payments to the broker, or that the broker conditions distribution of any covered security of the fund complex or other issuer to the receipt of rule 12b-1 fees in connection with other covered securities of that fund complex or other issuer. We agree that this is information that investors should have. But it is the type of information that investors need, not at the point of sale of a particular product, but at the outset of the relationship and for all products sold. That is when it can be used to help investors determine whether they want to work with a particular financial professional.

One reason our organizations have argued so strenuously for a reconsideration of the broker-dealer exclusion from the Investment Advisers Act is this very disclosure disparity, which requires investment advisers to provide this type of information at the outset of the relationship but doesn't require brokers to provide it at all. Getting the information regarding mutual fund conflicts on the website would be progress, but it simply is not comparable to the affirmative, comprehensive disclosure obligation that applies to investment advisers. Therefore, while we welcome the Commission's recognition that this is information that would be useful to investors, we see no reason why brokers, whose conflicts are arguably greater, should continue to be subject to disclosure obligations in this area that are weaker than those that apply to investment advisers. This continued disclosure disparity is particularly inexcusable in light of recent research that shows that investors fail to understand these distinctions between brokers and advisers.[12]

Specific Concerns about the Re-proposal

In addition to the broad concerns about the Commission's general approach to disclosure policy outlined immediately above, we have a number of specific concerns about the re-proposal,

[12] See survey released by Zero Alpha Group and CFA, available at www.zeroalphagroup.com and TD Waterhouse 2004 U.S. Investor Perception Study.

as discussed below.

Content of Disclosures. The purpose of the POS disclosures is to reveal sales-related costs and conflicts of interest. However, the proposed POS disclosures refers only obliquely to compensation received by the broker and does little to draw the customer's attention to conflicts inherent in the compensation arrangements. The POS disclosures include the amount of sales charges and 12b-1 fees, for example, but with regard to the broker's receipt of these payments, the document states only "we receive all or almost all of the distribution fees."[13] Otherwise, the only references to the broker's receipt of selling compensation are the yes/no answers to the general questions about whether the fund pays more to the broker, or the broker to the registered representative, for promoting this fund over other funds. As a result, the disclosures do little to apprise investors of the broker's incentive to favor a particular fund or class of shares that pays the highest compensation rather than the fund or class that is the best investment for the customer.

To understand issues of costs and conflicts of interest, the investor needs to understand what they are paying to compensate the broker, what conflicts of interest may bias the broker's recommendations, and the extent of those conflicts. However, the revised POS disclosures don't actually convey any of that information as clearly as they should or could. They don't clearly convey what is paid to compensate the broker for the services they provide in selling the fund. They don't mention that these sales charges can vary and that brokers have an incentive to sell funds that pay higher sales loads and distribution fees. Furthermore, because all comparative information has been removed, the documents fail to give any sense of the extent of the conflicts that may bias the broker's recommendations.

If investors are to understand sales-related costs, then all the information on those costs should be grouped together and clearly labeled as such. To accomplish this, the document's primary breakdown of information should be between what the investor pays for the services of the broker and what they pay for the operation of the fund. In disclosing what the investor pays for the broker's services, the document should note, if this is the case, that these payments include both a one-time payment of a sales load and an ongoing payment of distribution fees. These costs should then be disclosed. More testing should be done to determine how best to convey that information so that it is useful to the investor.

For investors to understand the extent of the conflicts associated with this compensation arrangement, the documents should also clearly state: 1) that different funds (and different classes of the same fund, if this is the case) provide different levels of compensation to the broker and 2) that brokers have an incentive to recommend funds that pay higher compensation. To put the costs in context, the documents should give some sense of the range of charges

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[13] It is not clear what disclosure must be provided if the broker receives only some of the distribution fee. We note that similar disclosure will be provided for B and C class shares.

imposed by similar funds.[14] None of this has to be any more complicated to disclose than the information provided on the current prototypes. (For example, the disclosure could indicate whether the sales load is average, below average, or above average or whether the broker receives the maximum amount of distribution fees funds are permitted to provide.) Rather than decide in advance, however, what form these disclosures should take, testing should be used to determine the best way to convey this information.[15]

Revenue Sharing:[16] We are particularly concerned about the Commission's treatment of revenue sharing in the POS disclosures. The POS disclosures would not include *any information* about the amount of revenue sharing payments received by the broker. As a result, investors will be left with no information to use in assessing the extent to which these payments may influence the broker's recommendations. Yet revenue sharing payments are often little more than a form of legalized payola – the price brokers exact from fund companies to ensure access to their customers. Investors receive no benefit. Fund companies that can't or won't make the payments are discriminated against. Only brokers benefit by using their position as gatekeeper to exact additional pay.

We are sympathetic to the argument that these payments are difficult to disclose clearly. However, that is an argument for banning revenue sharing payments, not for relegating all meaningful disclosure to the website. If you believe, as we do, that brokers are likely to gravitate toward compensation arrangements for which they don't have to provide full disclosure, it is logical to conclude that the approach proposed by the Commission will actually encourage

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[14] The Commission indicates in its re-proposal that it will request further comment about comparative range disclosure requirements in a later release. (See Release at n.5.) While we would prefer to see comparative information included in the POS document without additional delay, we encourage the Commission to proceed promptly with its additional request for comment on this issue.

[15] Even the enhanced disclosure that we support, however, is likely to be adequate on its own to address problems related to the current compensation system. We continue to recommend, as discussed in our previous letter, that the Commission take steps to separate brokers' compensation from fund fees by substantially amending rule 12b-1 and by encouraging Congress to revisit Section 22(d). These provisions have helped to create a system in which funds compete to be sold, by offering financial incentives to the salesperson, rather than competing to be bought, by offering a good product and good service at a reasonable price. If funds were removed from the rule of fixing broker compensation, mutual fund investors would benefit in two ways: broker compensation levels would be subject to the same market forces that have driven down commissions for stock transactions and the incentive for brokers to recommend funds that are not in their customers' best interests would be sharply reduced.

[16] We use the term "revenue sharing" to describe payments made by fund managers and their affiliates to fund distributors and their affiliates in connection with the sale of fund shares.

increased use of this conflict-laden compensation arrangement and other similar, undisclosed arrangements. The Commission should not adopt an approach that allows brokers to reduce the appearance of conflicts of interest by shifting their compensation to the least transparent compensation method. For that reason, we believe disclosures of all types of compensation should be designed to give a sense of the degree of conflict created.[17]

Internet, Oral and Toll-Free Number Disclosure: Not only does the re-proposal relegate important information – such as information about revenue sharing payments to website or toll-free number disclosure – it also continues to contemplate allowing brokers to provide the POS disclosures orally over the phone. We believe that, as a general matter, there is no substitute for contemporaneous, written disclosure. As we have previously noted, the greater the sales compensation or differential compensation received, the greater will be the broker's incentive not to disclose this information clearly and completely. If brokers are allowed to satisfy their disclosure obligations orally, in practice we will see an inverse relationship between the need for disclosure on the one hand, and the incidence of *actual* full and clear disclosure on the other. After all, brokers already have a general obligation to inform their customers about key aspects of the funds they recommend. It is the very failure of this oral disclosure regime that has prompted calls for a POS document.

The justification offered for permitting oral disclosure is that it is necessary to continue to allow brokers to both recommend a mutual fund and complete the sale in a single sales call. There is no evidence that this approach to fund sales benefits investors, since it deprives them of any opportunity to consider the broker's recommendations carefully with all the facts before them. And, contrary to the picture brokers paint, there is rarely a compelling need (or likely even a compelling desire) to complete the transaction on such a short time frame. Furthermore, this approach is being contemplated despite the fact that there is no basis for believing oral disclosures will be as effective in conveying essential information to investors as written disclosures would be. We are not aware, for example, that the Commission has made any effort to determine whether the disclosures can be provided effectively in this manner. As we have noted above, in cases such as this, we believe investors' need for clear disclosures about conflicts of interest should outweigh considerations of brokers' preferred practices.

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[17] The Commission indicates that investors who reviewed the information on costs and conflicts were more interested in receiving cost information than conflict information. One reason may be that basic conflict of interest information is more relevant to the selection of the financial professional than the evaluation of a particular product recommendation. Once the investor has chosen to rely on a broker's recommendations, they are unlikely to second-guess that decision based on last-minute conflict disclosure. Another reason, however, may be that the Commission has not yet done a good job of disclosing conflicts of interest in a way that alerts investors to the very real risk that brokers subject to those conflicts will recommend products that are not in the investor's best interest. Rather than abandon the effort, the Commission should do more testing to determine whether more effective disclosures can be designed that providing this warning.

While we do not believe important disclosures should be relegated to the Internet, or to toll-free numbers, we do believe electronic communications methods have the potential to accommodate both brokers' desire for speed and investors' need for clear, written disclosures. In any case where the investor has access to a fax machine or email, the completed disclosure form could be sent to the investor by fax or as an attachment to or link in an email message. The broker could then walk the investor through the document, just as he or she would in a face-to-face meeting. Similarly, if the investor can be on the phone and on the Internet at the same time, the investor could view the document on-line while reviewing it with the broker. Given the potential for these communications methods to allow written disclosure during phone calls, we believe brokers should be required to determine whether any of these alternatives for written disclosure are available. They should only be allowed to rely on oral disclosures – if at all – in what we believe would be the relatively rare circumstances where no such alternative exists.

Multi-class Funds: Abuses involving the inappropriate sale of B shares clearly demonstrate the need to provide investors with better information with which to determine whether the fund class being recommended is in their best interest. Because the POS disclosures provide information on only one class of shares at a time, however, they will not effectively accomplish this goal unless all relevant versions are provided. However, in this regard the Commission states only that it "hope[s] that investors would request, and broker-dealers would provide, forms for different share classes where applicable and where consistent with suitability obligations, in order to help investors make informed investment decisions."

We are dismayed that, despite widespread, documented abuses in this area, the Commission apparently does not believe it is necessary to better apprise investors of conflicts of interest created by the sale of different classes of shares. The Commission should not allow its hope to triumph over its experience, which has been that the brokers who are most likely to make inappropriate sales of B shares are also the least likely to provide their customers with relevant disclosures. The Commission should conduct further testing to determine the best way to disclose this information in a way that is likely to be used and understood by investors. One approach worth testing would be to require disclosure of a line graph showing the relative distribution expenses paid by the investor over time for each class of shares the investor is eligible to purchase. If coupled with a warning about conflicts of interest, such an approach might serve to put investors on notice that their interests were not being served.

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In conclusion, while we believe more can and should be done to perfect this proposal, we nonetheless applaud the Commission's obviously genuine efforts to improve disclosure of costs and conflicts of interest associated with the sale of mutual funds. Business interests often unite in powerful opposition to reforms that promote free, efficient markets and threaten the livelihood of service providers who could not compete effectively if their compensation arrangements were fully disclosed. Notwithstanding our criticisms of the re-proposal, we appreciate that requiring brokers to provide their customers with basic information about funds at the point of sale is by

itself a watershed event in the history of the regulation of mutual funds. Our criticisms are driven, not by a failure to recognize and appreciate that progress, but by a desire to make the most of this possibly unique opportunity to improve these critical disclosures.

We therefore commend the Commission for its efforts to improve fund fee disclosure and promote competition, and thereby create wealth for tens of millions of mutual fund shareholders. We look forward to working with the Commission as it moves toward finalizing the new rules.

Respectfully submitted,

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